

## **Office of the State Controller**

### Self-Assessment of Internal Controls

#### **Tax/Payroll Compliance Cycle**

##### Payroll Compliance-Determination of Employment Relationship for Tax Reporting and Withholding Requirements

### **EMPLOYEE VERSUS INDEPENDENT CONTRACTOR**

Generally an employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which it is to be accomplished. That is, an employee is subject to the will and control of the employer not only as to **what** shall be done but **how** it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which their services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer but not necessary in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result, he is an independent contractor. An individual performing service as an independent contractor is not as to such services an employee under the usual common law rules. Individuals such as physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in the pursuit of an independent trade, business or profession in which they offer their services to the public are independent contractors and not employees.

### **TYPES OF EMPLOYMENT RELATIONSHIPS**

There are four common types of employment relationships recognized by the Internal Revenue Service. These relationships are as follows:

1. A common law employee;
2. An independent contractor
3. A common statutory employee; or
4. A statutory nonemployee.

### **INDEPENDENT CONTRACTOR**

Individuals who follow an independent trade, business or profession are generally not employees. This category includes lawyers, contractors, subcontractors, accountants, auctioneers, etc. who offer their services to the general public. The general rule of thumb is that an individual is an independent contractor if you, the employer, have the right to control or direct only the result of the work and not the means and method used to accomplish the result. You do not have to withhold or pay income or social security taxes on payments you make to independent contractors. Usually they will be sent a Form 1099-MISC at the end

of the year if the payments made during the year aggregate to more than \$600. Backup withholding may be required if the independent contractor does not furnish a Federal Identification Number.

## **COMMON LAW EMPLOYEE**

Under the old common law rules, every individual who performs services that are subject to the will and control of an employer, as to what must be done and how it must be done, is an employee. If you have an employee relationship, it makes no difference how it is described. Consequently, it does not matter if the employee is called an employee, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Also, it does not matter if the employee is full-time, part-time, or an employee hired for a short period.

Two of the usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies the tools and a place to work. In an employee relationship, it does not matter if the employee is full-time or part-time and there is no distinction between classes of employees, i.e. managers, supervisors or other types of personnel. Income taxes and social security will have to be withheld on payments made to common-law employees. In addition, the agency is responsible for the employer's portion of the FICA and must make contributions to the Employment Security Commission or to the Trust Fund set up to cover payments to eligible unemployment compensation recipients. Common-law employees will receive a Form W-2 at the end of the calendar year for all compensation received during the year.

## **STATUTORY EMPLOYEE**

A statutory employee is an individual who works for you but is not an employee within the meaning of common law employee as described above. The types of statutory employees are:

1. An agent or someone who is paid on commission.
2. A full-time life insurance sales agent who works primarily for one insurance company.
3. An individual who works at home on materials or goods which you, the employer, supply and which must be returned to you, the employer or someone you specify.
4. A full-time traveling or city salesperson that works on the employer's behalf and turns in orders from wholesalers, retailers, contractors, or operators of various establishments. The work performed must be the salesperson's principle business activity.

Federal income taxes on payments made to statutory employees do not have to be made. Social security, however, must be withheld. Payments must be made for unemployment compensation purposes for categories (1) and (4) above. A statutory employee will receive Form W-2 at the end of the year.

## **STATUTORY NONEMPLOYEE**

Statutory nonemployees include direct sellers and licensed real estate agents. Direct sellers are individuals who engage in selling in the home or at a place of business other than in a permanent retail establishment. Payments for services to these individuals are related to sales or other output rather than to number of hours worked. Income taxes on payments made to statutory nonemployees do not have to be withheld or paid. Statutory nonemployees will receive a Form 1099-MISC at the end of the year.

## **PART-TIME WORKERS**

For income tax withholding, social security, and federal unemployment tax purposes, there are no differences between full-time, part-time, and employees hired for short periods. It does not matter whether the worker has another job or has the maximum amount of social security tax withheld by another employer. Income tax withholding may be figured the same way as for full-time employees.

## **COMMON MISCLASSIFICATION FOR A GOVERNMENTAL EMPLOYEE**

One of the major differences between a governmental employer and a private sector employer is the presence of budgetary constraints. While a private employer may develop a budget to assist in the planning and operation of its business, this budget does not become the binding legal document that it becomes for a governmental employer. It is the effort to remain within the constraints of the budget process that can possibly cause a misclassification of workers for FICA and FITW purposes. The following are examples of the problem areas an agency may encounter:

- An employee may retire and return to work under a personal service contract to assist in the training of the replacement, to help out during a busy time, or on a permanent part-time basis. Although not a budgeted position, this worker may still be your employee for FICA and FITW purposes.
- Due to an increased work load, there may be a need to hire workers although a budgeted position may not be presently available. Sometimes this is done with the intent of placing the worker in a budgeted position at such time as it is approved or becomes available. The worker may still be an employee for purposes of FICA and FITW.
- When a critical position is about to become vacant through retirement, transfer, or for whatever reason, it is sometimes necessary to find a replacement and have the replacement trained before the position actually becomes available. Although the worker is not in a budgeted position while working under a personal service contract, the replacement may still be an employee for the purposes of FICA and FITW.
- When an employee is on extended leave for medical (including maternity), educational, military or for other purposes, it may be necessary to have his/her work performed by a temporary worker. In the past, the worker providing backup service has often been paid under a personal service contract. While acceptable for budgetary purposes, this may not be

correct for purposes of FICA and FITW.

- It may be necessary to contract with a worker to provide a service that would normally be provided by an employee, except for the fact the State's salary schedule is not satisfactory to attract qualified personnel. In this instance the contracted worker may be an employee for purposes of FICA and FITW.

When reviewing the status of a personal service contract, the substance of the relationship with the person involved will be the controlling factor when in conflict with the actual form of the contract. Therefore, even though the worker's contract contains statements to the effect "this is not to be considered an employee relationship," "worker acknowledges he is responsible for all applicable taxes," or "worker is to be considered an independent contractor," etc., will not take precedence if, under the common law factors, the State exercises sufficient control over the worker to establish an employment relationship.

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Determination of Employment Relationship for Tax Reporting  
and Withholding Requirements

Control Policies and Procedures

Agency \_\_\_\_\_

Year-End \_\_\_\_\_

**A. Documentation**

Yes No N/A

\_\_\_ \_\_\_ \_\_\_ 1. Is there a formal plan of organization under which responsibilities are assigned for identifying a worker as an employee or independent contractor?

Name of person responsible: \_\_\_\_\_

Title: \_\_\_\_\_

\_\_\_ \_\_\_ \_\_\_ 2. Does the agency have written instructions available for responsible agency personnel to use as a guide for consistent, accurate determination of employment relationship?

**B. Recording and Execution of Transaction and Events**

Yes No N/A

\_\_\_ \_\_\_ \_\_\_ 3. Does they agency contract with workers to provide personal services, other than employees in regular budget positions?

\_\_\_ \_\_\_ \_\_\_ 4. For contracted workers, has an effort been made to determine whether an employment relationship possibly exists with such worker?

\_\_\_ \_\_\_ \_\_\_ 5. Where the agency has found to have entered into an employment relationship with a worker, have the payments been reported to the worker on a Form W-2 with all applicable taxes withheld?

\_\_\_ \_\_\_ \_\_\_ 6. Is all applicable personnel action performed?

Name of person responsible: \_\_\_\_\_

Title: \_\_\_\_\_

\_\_\_ \_\_\_ \_\_\_ 7. Has consideration been given to the benefits that should be given to workers reclassified as employees under the IRS's Common Law factors?

\_\_\_ \_\_\_ \_\_\_ 8. Are efforts being made to place reclassified workers in a budgeted position (temporary full-time, part-time, etc.)?